The Navigator

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U.S. residency – Canadians travelling to the U.S. beware

U.S. income tax residency rules could affect you

If you are a Canadian resident who spends extended time in the U.S., you may be required to file a U.S. income tax return and may have other U.S. filing obligations. Being aware of U.S. laws and the obligations imposed by them can help you to avoid unpleasant surprises and costly penalties.

There is a popular misconception that Canadians can spend up to 182 days per year in the U.S. without being considered a resident for income tax purposes. In reality, the U.S. Internal Revenue Service (IRS) applies a formula known as the "substantial presence test" to determine if you are a U.S. resident for tax purposes. This formula looks at your time in the U.S. over a three year period. Meeting the test means you may need to file a U.S. tax return; but there are exceptions.

This article provides a basic overview of U.S. residency under U.S. income tax laws, the circumstances where U.S. income tax and reporting obligations may arise and the options available if you are considered a U.S. resident for tax purposes.

In this article where we refer to "Canadian or Canadians" it assumes you are a Canadian resident and not a U.S. citizen or green card holder.

This article outlines strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal or tax advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax and/or legal advisor before acting on any of the information in this article.

If you meet the test, you may be subject to U.S. income tax and have other U.S. reporting obligations, similar to a U.S. citizen.

U.S. residency and U.S. tax obligations

The basis for U.S. income taxation is U.S. citizenship and U.S. residency. If you are a Canadian who is not a U.S. citizen, you may be a U.S. resident if you are a U.S. green card holder or you meet the substantial presence test. If you meet the test, you may be subject to U.S. income tax and have other U.S. reporting obligations, similar to a U.S. citizen. This may include having to file a U.S. income tax return (IRS form 1040) as a resident of the U.S. and pay tax on your worldwide income (including Canadian source income). However, you will be entitled to the same deductions and personal exemptions available to U.S. citizens. In addition, you may have to file other U.S. forms that require you to disclose information such as financial accounts you own that are located outside the U.S.

Canadians who meet the substantial presence test have options under U.S. tax rules or under the Canada-U.S. Income Tax Convention (Treaty), described later, to qualify for various forms of relief from the obligations of U.S. residency status. However, if you choose to claim relief under the Treaty, you may still have to file other U.S. forms generally required by U.S. citizens and residents.

If you are a Canadian resident who is not a U.S. resident, you are only subject to U.S. income tax on income from U.S. sources. You generally do not file a U.S. income tax return if you are simply earning U.S. investment income, such as U.S. dividend income, since your U.S. tax obligation is generally paid through withholding tax. However, there are circumstances where you may need to file or elect to file a U.S. non-resident tax return. These are briefly discussed later.

Determining U.S. residency status under the substantial presence test

The substantial presence test is a two-step test that applies to individuals who are not U.S. citizens or green card holders.

Step 1: Were you physically present in the U.S. for at least 31 days in the current year?

If you were not present in the U.S. for at least 31 days in the current year, you automatically do not meet the test. You are a U.S. non-resident for U.S. income tax purposes.

If you were present in the U.S. for 183 days or more in the current year, you automatically meet the test.

You are a U.S. resident for U.S. income tax purposes.

If you were present for more than 30 days but less than 183 days, you need to go to step 2 to determine whether you meet the test.

Step 2: Does the total number of days you spent in the U.S. over the last three calendar years equal or exceed 183 days based on the following formula?

Formula:

Add all the days you spent in the U.S. in the current calendar year;

plus

1/3 of the days you spent in the U.S. in the previous calendar year (i.e. first year before the current year);

plus

1/6 of the days you spent in the U.S. in the calendar year before the previous year (i.e. the second year before the current year).

If the total number of days using the formula above amounts to 183 days or more, you meet the substantial presence test. You are a U.S. resident for U.S. income tax purposes for the current year.

If the total number of days using the formula above amounts to less than 183, you do not meet the substantial presence test. You are a U.S. non-resident for U.S. income tax purposes.

When counting the number of days present in the U.S., even if you are present for part of a day, you must count that day as a full day. For example, a 10-minute trip across the border counts as a full day. However, there are certain exceptions. For example, you can exclude days you regularly commute to work in the U.S. from Canada, days you were unable to leave the U.S. due to a medical condition that arose in the U.S. and the days you were in transit in the U.S. for less than 24 hours while traveling between two places outside of the U.S. (e.g., you have a layover in Chicago on your way to Uruguay). Certain individuals such as foreign government officials, students and teachers or trainees may exempt days of presence in the U.S. if they are temporarily present under certain visas and comply with the requirements of that visa. Talk to a qualified tax advisor for more information on how to count your days of presence in the U.S. for tax purposes.

Substantial presence test calculation example

Let's assume you spent 130 days in the U.S. in each of the last three years. The calculation to determine whether you are a U.S. resident for the current year would be as follows:

Since you spent at least 31 days in the U.S. in the current year you may be a U.S. resident under step 1. However, because you spent less than 183 days in the U.S. in the current year, you are not automatically a U.S. resident under step 1 and we must look at step 2.

For step 2, the formula results in 195 days of presence in the U.S. over the last three years, calculated as follows:

- 130 days in the current year, plus
- 43 days in the previous year (130 days multiplied by 1/3), plus
- 22 days in the year before the previous year (130 days multiplied by 1/6)

Since 195 days (130 days + 43 days + 22 days) is equal to or greater than the 183 day guideline, in this example, you meet the substantial presence test for the current year.

As a rule of thumb, if you spend more than four months (122 days) every year in the U.S., you will meet the substantial presence test after the third year and annually thereafter, and you will be considered to be a U.S. resident. Therefore, it would be incorrect to assume you can spend up to 182 days every year in the U.S. (which may be the case for U.S. immigration purposes) and not be considered a U.S. resident for income tax purposes.

The quick reference box summarizes the substantial presence test and may assist you in determining your U.S. residency status.

Are you a U.S. resident? – Quick reference box

You are considered a U.S. resident if you spend:

- At least 183 days in the current year in the U.S.,

OR

- You spend at least 31 days in the current year in the U.S. and you meet the substantial presence test:

Substantial Presence Test - Formula:

Add all the days you spent in the U.S. in the current calendar year ;

plus

1/3 of the days you spent in the U.S. last year;

plus

1/6 of the days you spent in the U.S. in the year prior to last year

If the total equals at least 183 days, you are considered a U.S. resident alien for U.S. tax purposes in the current year.

Are you a non-resident of the U.S.? – Quick reference box

You are a non-resident of the U.S. if you spend :

- Less than 31 days in the U.S. in the current year, or
- At least 31 days in the U.S. in the current year but you do not meet the substantial presence test

Canada and the U.S. now share information about when you enter and leave your respective countries.

U.S. immigration versus income tax laws

It is important to recognize that there are differences in U.S. immigration laws versus U.S. income tax laws for Canadians visiting the U.S. From an immigration perspective, the U.S. Customs and Border Protection (CBP) generally limits your presence in the U.S. to six months in a rolling twelve-month period, or 180 days in a rolling year. Also, the manner in which your days of stay in the U.S. are counted for U.S. immigration purposes may be different. Speak to a legal professional with expertise in U.S. immigration laws for further information.

Canadians should be careful not to confuse the U.S. immigration laws with the U.S. income tax laws. This may result in the misconception that you can visit the U.S. and stay for six months every year without being deemed a U.S. resident under the U.S. income tax laws.

The U.S. tracks your days of presence in the U.S.

Canada and the U.S. now share information about when you enter and leave your respective countries. As a result, the U.S. is able to track your days of presence in the U.S.

The CBP provides online access to a report of your border crossing at the following website: https://i94.cbp.dhs.gov/I94/request.html. To access the information, you will require several pieces of information found on your passport including country of issuance, passport number, full name and date of birth.

This information may be used by the U.S. to enforce both U.S. immigration and income tax laws.

Options for U.S. residents under the substantial presence test

There are two options to qualify for relief from status as a U.S. resident. Under U.S. income tax rules you may be able to claim the "closer connection exception" and under the Treaty, you may be able to claim a "treaty exemption".

Closer connection exception – For Canadians who spent less than 183 days in the U.S. in the current year

You may claim the closer connection exception to be considered a U.S. non-resident provided you have not applied for or do not hold a U.S. green card. If you successfully claim this exception, you will not have to file a U.S. resident tax return or other U.S. forms discussed later and you will not be taxable in the U.S. on your worldwide income.

To claim the closer connection exception you must complete U.S. form 8840 - Closer Connection Exception Statement for Aliens, and show that you have a closer connection with Canada. The following factors will indicate you have a closer connection with Canada:

- Your permanent home is in Canada;
- Your family is located in Canada;
- Your business activities are carried on in Canada;
- You own personal property in Canada such as a car, furniture, or jewellery;
- You hold a Canadian drivers license;
- You have memberships in social organizations in Canada;
- You are registered and vote in Canada;
- You belong to religious, political or cultural organizations in Canada; and
- You have a bank account in Canada.

If you can successfully claim the treaty exemption, you will not have to file a U.S. resident tax return and pay U.S. tax on your worldwide income; however, you may have to file other U.S. forms.

Filing requirements, deadlines and penalties

If you are filing Form 8840 to claim a closer connection to Canada and you are not required to file a U.S. non-resident tax return, you can mail Form 8840 directly to the U.S. tax authorities by its due date of June 15th of the following year. If you are filing a U.S. non-resident tax return then Form 8840 is attached and filed with your return by its due date of June 15th of the following year. If you were an employee and received wages subject to U.S. income tax withholding, your U.S. non-resident tax return and the Form 8840 would be due by April 15th of the following year.

If you do not file Form 8840 by the due date, you will not be eligible to claim the closer connection exception and may be treated as a U.S. resident which means you may have to file a U.S. resident income tax return. In this case you may be able to file a U.S. non-resident alien tax return and attach a treaty statement claiming a treaty exemption as discussed later. However, you may still be subject to non-disclosure penalties under the IRS tax laws, which could amount to as much as $1,000 for failing to disclose a treaty-based position.

For further information on Form 8840, you can refer to the form and filing instructions, which are available on the IRS website at http://www.irs.gov/ or speak to a qualified tax advisor.

Treaty exemption – For Canadians who spent over 183 days in the U.S. in the current year

You may claim a treaty exemption to be deemed a resident of Canada and a non-resident of the U.S. If you can successfully claim the treaty exemption, you will not have to file a U.S. resident tax return and pay U.S. tax on your worldwide income; however, you may have to file other U.S. forms discussed later. Talk to a qualified tax advisor regarding your eligibility to make the claim.

In general, to claim a treaty exemption, you must be deemed to be a resident of Canada under the provisions contained in the Treaty called the "treaty tie breaker rules". You are considered to be a resident for income tax purposes by each country's domestic tax rules; however, the treaty tie breaker rules may be used to ultimately determine which country you are deemed a resident of for income tax purposes.

Here is some general information about the treaty tie breaker rules. If the first treaty tie breaker rule demonstrates that you have a permanent home available for your use only in Canada you may tie break to Canada. If you have a permanent home available for your use in both Canada and the U.S., then you have to look at the second treaty tie breaker rule, which looks at where your centre of vital interests are closer. Your centre of vital interest refers to your personal and economic ties. Examples of where your centre of vital interests are closer to Canada are if your family is located in Canada, you are carrying on a business in Canada, your bank accounts, social memberships, religious organizations are located in Canada, you are registered and you vote in Canada. If your centre of vital interests is closer to Canada and you do not have these same ties in the U.S., you may tie break to Canada. If you are treated as a resident of Canada under the Treaty, you are treated as a non-resident of the U.S. in figuring your U.S. income tax and may be eligible to claim a treaty exemption. For purposes other than figuring your U.S. tax, you will be treated as a U.S. resident.

Filing requirements, deadlines and penalties

If you claim the treaty exemption to claim U.S. non-resident status for U.S. income tax purposes, you must file a U.S. non-resident tax return (1040NR) and attach a treaty exemption statement (Form 8833),

If you do not file an income tax return or pay the tax that is due, the IRS may levy a failure-to-file penalty and a failure-to-pay penalty.

which indicates that you are a resident of Canada under the Treaty. You will report and pay tax only on U.S. source income.

If you are required to file Form 8833, it is filed together with your 1040NR, which is generally due by June 15th of the following year. If you were an employee and received wages subject to U.S. withholding tax, your U.S. non-resident tax return and the Form 8833 would be due by April 15th of the following year.

If you do not file an income tax return or pay the tax that is due, the IRS may levy a failure-to-file penalty and a failure-to-pay penalty. Each of these penalties is calculated based on a percentage of the income tax liability that remains unpaid. The failure-to-file penalty is generally 5% of the tax owed for each month or part of a month up to a maximum of 25% of the unpaid tax. The failure-to-pay penalty is 0.5% for each month, or part of a month, the amount is unpaid up to a maximum of 25% of the amount that remains unpaid. The IRS may also charge interest on the unpaid tax.

If you were present in the U.S. for more than 183 days in a particular year you may be required to complete and file other U.S. forms even if you successfully claim the treaty exemption to be treated as a non-resident alien for figuring your U.S. tax. An example of a U.S. form you may need to file is the FinCEN Report 114, *Report of Foreign Bank and Financial Accounts (FBAR)*. This form must be filed electronically and is required if at any time in the year the aggregate value of foreign bank and financial accounts you own, have an indirect interest in, or have signing authority over, exceeds US $10,000. Examples of foreign bank and financial accounts are Canadian bank or brokerage accounts, registered retirement and education savings plans (RRSPs, RESPs), locked-in retirement plans (LIRAs, LIFs, LRIFs and PRIFs) and Tax-Free Savings Accounts (TFSAs).

FinCEN Report 114, Report of Foreign Bank and Financial Accounts (FBAR) is not mailed with your income tax return. The Department of the Treasury requires this form to be completed and sent electronically on or before June 30th of the following year. There are no extensions to file available for this form. A penalty of up to US $10,000 can be levied for failure to properly file this form. In addition, if you wilfully fail to report an account or account identifying information, you may be subject to a penalty equal to the greater of US $100,000 or 50% of the balance in the account at the time of the violation. The Treaty does not protect you from these penalties.

For further information on filing the Form 8833 or the FBAR refer to the forms and filing instructions, which are available on the IRS website at http://www.irs.gov/ and speak to a qualified tax advisor regarding these and other filings that may be required. Talk to your tax advisor regarding any other US forms you may be required to file.

You do not meet the substantial presence test – but you earned U.S. source income:

As we indicated before, non-residents of the U.S. generally do not have to file a U.S. non-resident income tax return if they earn U.S. investment income, such as U.S. dividend income, and there was proper tax withheld at source. However, if you are engaged in a trade or business in the U.S. you may be required to file a U.S. non-resident tax return (1040NR). Some examples of when you may be engaged in a trade or business in the U.S. are if you earn wages in the U.S. or you sell U.S. real estate. You may also elect to file a U.S. non-

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resident income tax return if you earn rental income from a U.S. real estate property in order to pay U.S. tax on your net rental income rather than your gross rental income. For further information regarding owning U.S. real estate ask your RBC advisor for a copy of our article, "Canadian Owners Renting or Selling U.S. Real Estate".

Monitor your status

It is important to monitor your presence in the U.S. for both U.S. immigration and income tax laws. For U.S. income tax purposes, you should consult with a qualified tax advisor familiar with Canada-U.S. income tax laws to determine your U.S. residency status. They can help you determine if your situation qualifies for relief under the closer connection exception or the treaty exemption and provide you with assistance in completing the necessary U.S. filings.

Please contact us for more information about the topics discussed in this article.

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